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Message Text

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INFO OCT-01 AF-06 ARA-06 EUR-12 EA-06 NEA-10 IO-10 ISO-00

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KUWAIT PASS BAGHDAD GENEVA FOR GATT

E.O. 11652: N/A

TAGS:EFIN, ENRG, OECD

SUBJECT:DRAFT IEA POSITION PAPER ON INDEXATION OF OIL PRICES.

REF: STATE 171614

1. THIS MESSAGE TRANSMITS TEXT OF DRAFT IEA POSITION PAPER ON ISSUE OF INDEXATION OF OIL PRICES. PAPER WILL BE RE-VIEWED BY IEA AD HOC GROUP ON FINANCIAL AND INVESTMENT ISSUES AT SEPETEMBER MEETING. THE PAPER THEN, AS MODIFIED BY THE AD HOC GROUP, WILL BE SENT TO THE IEA GOVERNING BOARD AS A PROPOSED IEA POSITION PAPER ON THE ISSUE.

2. CHAIRMAN OF THE AD HOC GROUP, TREASURY ASSISTANT SECRE-TARY PARSKY, WILL ATTACH COPY OF PAPER TO HIS JULY 28 RE-PORT TO THE GOVERNING BOARD AND NOTE THAT HE HAS SENT THE DRAFT PAPER AS A CHAIRMAN'S NOTE TO THE MEMBERS OF THE AD
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HOC GROUP FOR THEIR REVIEW. HE WILL NOT COMMENT ON THE SUB-STANCE OF THE PAPER AND DOES NOT ANTICIPATE SUBSTANTIVE DISCUSSION ON THE ISSUE AT THE JULY 28 MEETING.

3. TO ALL IEA CAPITALS. PLEASE PASS THE TEXT OF THE DRAFT POSITION PAPER BELOW TO APPROPRIATE MINISTRY OF HO T GOVERN-MENT. PLEASE NOTE PARSKY'S REQUEST IN REFTEL

FOR COMMENTS ON DRAFT AS SOON AS POSSIBLE SO THAT REVIS-ED DRAFT CAN BE PREPARED AND DISTRIBUTED PRIOR TO SEPTEM-BER MEETING. REQUEST THAT PAPER BE TREATED AS IEA - CONFIDENTIAL.

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4. TO US MISSION OECD PARIS. PASS PAPER TO IEA SECRETARIAT AND REQUEST IT BE CLASSIFIED IEA - CONFIDENTIAL. MAKE SURE SECRETARIAT RECOGNIZES IT IS CHAIRMAN'S NOTE TO MEMBERS OF AD HOC GROUP PROPOSING TEXT OF AN IEA POSITION PAPER AND IT HAS TO BE REVIEWED BY THE AD HOC GROUP.

5. COMMENT:ALL POSTS SHOULD RECOGNIZE THAT PAPER DRAFTED WITH OBJECTIVE OF OBTAINING IEA AGREEMENT ON POSITION PAPER AND USG POSITION MAY NOT BE IDENTICAL IN ALL RESPECTS.

6. BEGIN TEXT. CHAIRMAN'S NOTE TO IEA AD HOC GROUP ON FINANCIAL AND INVESTMENT ISSUES, DRAFT IEA POSITION PAPER, INDEXATION OF OIL PRICES.

ISSUE

A. THE OIL EXPORTING COUNTRIES ARE NOW CONSIDERING VARIOUS "INDEXATION" PROPOSALS AIMED AT MAINTAINING THE REAL VALUE OF THEIR OIL EXPORTS. RECENTLY THEY HAVE ADDED THE SUGGESTION THAT THE PRICE OF OIL BE DOMINATED IN THE SDR UNIT OF ACCOUNT RATHER THAN IN THE U.S. DOLLAR IN ORDER TO PROTECT THE REAL VALUE OF OPEC OIL RECEIPTS FROM A DECLINE IN THE VALKE OF THE DOLLAR IN THE FOREIGN EXCHANGE MARKETS. THIS POSITION PAPER DEALS ONLY WITH CHANGES IN OPEC IMPORT PRICES.

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B. "INDEXATION" FOR PURPOSES OF THIS PAPER IS DEFINED AS AN INSTITUTIONAL DEVICE BY WHICH THE PRICE OF OIL IS PERIODICALLY ADJUSTED TO OBSERVED PAST VARIATIONS IN THE PRICE OF A MARKET BASKET OF GOODS AND SERVICES.

DISCUSSION

C. INDEXATION OF OIL PRICES, WHICH IN EFFECT FREEZES THE PRICE OF OIL RELATIVE TO THE PRICE OF A CHOSEN BASKET OF OTHER COMMODITIES, WOULD DISTORT RESOURCE ALLOCATION, INVESTMENT PATTERNS AND TRADING PATTERNS. IT MAKES NO MORE ECONOMIC SENSE TO TIE THE PRICE OF OIL TO SOME GENERAL PRICE INDEX THAN IT WOULD TO TIE THE PRICE OF OTHER COMMODITIES TO SUCH AN INDEX. PRICE CHANGES FOR

EACH PARTICULAR PRODUCT SHOULD SERVE THE ESSENTIAL ECONOMIC FUNCTION OF STIMULATING OR REDUCING ITS OWN DEMAND AND SUPPLY IN LINE WITH CHANGING MARKET CONDITIONS. AN EFFORT TO SET PRICES ON THE BASIS OF ARBITRARY PARITY PURCHASING POWER RATIOS THUS WOULD DISTORT THE MARKET'S

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ROLE IN THE ALLOCATION OF RESOURCES, RESULTING IN ARTIFICIAL SHORTAGES OR SURPLUSES. IT, THEREFORE, WOULD DETER WORLD ECONOMIC GROWTH AND PROGRESS.

D. INDEXATION AGREED TO BY THE CONSUMING COUNTRIES MAY BE INTERPRETED AS LEGITIMIZING OPEC'S ABILITY TO SET THE PRICE OF OIL AND COULD SOLIDIFY THE CARTEL. IT WOULD FURTHER REDUCE THE ROLE OF MARKET FORCES IN DETERMINING THE PRODUCTION AND DISTRIBUTION OF OIL.

E. OIL PRICE INDEXATION, STARTING FROM THE CURRENT BASE PERIOD, WOULD REQUIRE A FURTHER STRUCTURAL ADJUSTMENT IN THE ECONOMIES OF THE OIL IMPORTING COUNTRIES, THUS DELAYING THE RECOVERY IN THE WORLD ECONOMY. SINCE MANY FACTORS OF PRODUCTION ARE HIGHLY SPECIALIZED OVER THE SHORT-RUN AND YIELD LOW PRODUCTIVITY IN OTHER USES, STRUCTURAL UNEMPLOYMENT OF LABOR AND UNDER-UTILIZATION OF CAPITAL -- AND HENCE DECREASED REAL OUTPUT -- WOULD RESULT. THE LINKAGE OF OIL PRICES TO THE PRICES OF OTHER COMMODITIES WOULD ALSO BE DESTABILIZING TO WORLD TRADE.

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F. INDEXATION SCHEMES WOULD TEND TO INTENSIFY INFLATIONARY SPIRALS. THE 1973-74 OIL PRICE INCREASES ARE ESTIMATED TO HAVE CONTRIBUTED ABOUT ONE-THIRD OF THE PRICE INCREASE IN THE OIL IMPORTING COUNTRIES IN 1974. AS THESE PRICE INCREASES ADD TO WAGE PRESSURES, THEY WILL HAVE SECONDARY INFLATIONARY EFFECTS FOR SOME TIME. FURTHER OIL PRICE INCREASES BASED UPON INFLATIONARY TRENDS, WHICH WERE THEMSELVES INTENSIFIED BY EARLIER OIL PRICE INCREASES WOULD SERVE ONLY TO PERPETUATE A VICIOUS INFLATIONARY SPIRAL.

G. OIL PRICE INDEXATION WOULD ESTABLISH AN UNFORTUNATE PRECEDENT. OTHER PRIMARY PRODUCT PRODUCERS WOULD FEEL DISCRIMINATED AGAINST AND SEEK THE SAME TREATMENT. DURING THE PRODUCER/CONSUMER PREPARATORY CONFERENCE IN APRIL 1975, SEVERAL OF THE DEVELOPING COUNTRIES TOOK A STRONG PRO-INDEXATION STANCE REGARDING COMMODITIES OF INTEREST TO THEM (BRAZIL ON COFFEE, INDIA ON IRON ORE, AND ZAIRE ON COPPER). ONCE APPLIED TO OIL, THE CONCEPT OF INDEXATION IS LIKELY TO SPREAD FURTHER TO OTHER COMMODITIES.

AS IN THE CASE OF OIL, INDEXATION OF OTHER COMMODITIES WOULD SEND THE WRONG SIGNALS TO PRODUCERS AND EXCESS SUPPLIES OR SUPPLY SHORTAGES WOULD SURELY DEVELOP. WIDESPREAD INDEXATION OF COMMODITY PRICES WOULD LEAD TO INEVITABLE CONFLICTS OF INTEREST AMONG PRODUCERS OF DIFFERENT COMMODITIES, EACH OF WHICH WOULD LIKE TO MAXIMIZE ITS OWN EXPORT REVENUES.

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H. INDEXATION WOULD RESULT IN A FURTHER REDISTRIBUTION OF WORLD INCOME IF IT INCREASES OVER TIME THE REAL RESOURCE TRANSFER TO THE OIL-EXPORTING COUNTRIES FROM THE OIL-CONSUMING COUNTRIES -- WHICH, IT SHOULD BE STRESSED, INCLUDE LDC'S AS WELL AS DEVELOPED COUNTRIES. THE PATTERN OF THIS FORM OF RESOURCE TRANSFER WOULD BE LIKELY TO YIELD SERIOUS ANOMALIES SUCH AS TRANSFERS FROM LDC'S TO DC'S OR FROM POORER LDC'S TO NOT-SO-POOR LDC'S. IT WOULD BE A HIGHLY INEFFICIENT AND UNDESIRABLE METHOD OF INCOME REDISTRIBUTION.

I. THERE IS NO JUSTIFICATION FOR THE MAINTENANCE OF THE
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PRESENT TERMS OF TRADE OF OIL PRODUCERS. THE PRICE INCREASES FTR OIL, UNLIKE THE PRICE INCREASES FOR THE COMMODITIES THAT THE OPEC NATIONS IMPORT, HAVE CLEARLY NOT RESULTED FROM A STRAIGHTFORWARD EXCESS OF DEMAND OVER SUPPLY OR AN INCREASE IN PRODUCTION COSTS. THEY HAVE RESULTED, RATHER, FROM UNILATERAL ACTIONS ON THE PART OF THE GOVERNMENTS OF THE OIL-EXPORTING NATIONS. AND THEY HAVE BEEN MAINTAINED NOT THROUGH A CONTINUING TIGHT MARKET FOR OIL, BUT THROUGH CUTBACKS IN PRODUCTION TO MAINTAIN A PRICE WELL ABOVE THE FREE MARKET LEVEL. REFLECTING THESE PRODUCTION CUTBACKS, THE OPEC NATIONS NOW HAVE AN ESTIMATED 13 MILLION BARRELS A DAY OF EXCESS CAPACITY -- OR OVER A THIRD OF THEIR TOTAL PRODUCTIVE CAPACITY.

J. RECENT OIL PRICE INCREASES HAVE BEEN FAR IN EXCESS OF PRICE INCREASES FOR THE COMMODITIES THAT THE OPEC NATIONS IMPORT. THE OIL PRICE INCREASES HAVE SHARPLY AND SUDDENLY IMPROVED THE TERMS OF TRADE -- OR THE RATIO OF EXPORT TO IMPORT PRICES -- OF OIL PRODUCING COUNTRIES. THE PURCHASING POWER OF OPEC OIL AGAINST THE PRODUCTS IMPORTED BY THE OPEC COUNTRIES HAD REACHED AN ALL-TIME HIGH EVEN BEFORE THE OCTOBER 1973 OIL PRICE INCREASES. USING 1955 -- THE MOST FAVORABLE PREVIOUS YEAR (FROM THE OPEC POINT OF VIEW) FOR OPEC TERMS OF TRADE -- AS A BASE PERIOD, THE INDEX LEVEL FOR ARAMCO PAYMENTS PER BARREL OF OIL TO THE SAUDI ARABIAN GOVERNMENT HAD ALREADY REACHED 184 BY OCTOBER 1973, WHILE THE PRICE INDEX FOR EXPORTS BY THE 14 MAJOR INDUSTRIAL NATIONS HAD RISEN TO 178. BY DECEMBER 1974, AS A RESULT OF THE QUINTUPLING OF OIL PRICES, A BARREL OF OPEC OIL BOUGHT OVER 4 1/2 TIMES AS MUCH -- USING 1955 AS A BASE PERIOD -- AND 6 3/4 TIMES AS MUCH -- USING 1960 AS A BASE PERIOD.

K. A PRACTICAL PROBLEM CONCERNING INDEXATION IS THE SELECTION OF AN APPROPRIATE INDEX WHICH WOULD MEASURE THE

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PRICE CHANGES OF THEIR IMPORTS. THERE IS NO INDEX
REGULARLY AVAILABLE ON A CURRENT BASIS WHICH MEASURES
DIRECTLY THEIR IMPORT PRICES. THE OPEC ECONOMIC COMMISSION
BOARD IS UNDERTAKING THIS MONTH (JULY 1975) A STUDY OF THE
FEASIBILITY OF CONSTRUCTING SUCH AN INDEX. THIS STUDY IS
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TOBE PREPARED IN TIME FOR THE OPEC CONFERENCE TO BE HELD
IN SEPTEMBER 1975.

L. AS THE OPEC COUNTRIES DO NOT HAVE STATISTICAL SYSTEMS
ADEQUATE TO ALLOW THEM TO CONSTRUCT USEFUL IMPORT PRICE
INDICES, THEY WILL PROBABLY HAVE TO RELY FOR THE PRESENT
ON EXPORT PRICE INDICES FOR THE COUNTRIES FROM WHICH THEY
IMPORT. (NOTE: THESE INCLUDE THE UN INDEX OF MANUFACTURED
GOODS EXPORTS BY MAJOR INDUSTRIAL COUNTRIES AND THE IMF
INDEX OF EXPORT PRICES OF INDUSTRIAL COUNTRIES.) THESE
PRICES INDICES, OR AN INDEX WHICH MIGHT BE CALCULATED ON
THE BASIS OF REGULARLY PUBLISHED DATA, GIVE WIDELY DIFFERENT
RESULTS DEPENDING UPON WHICH INDEX IS USED AND WHICH BASE
PERIOD IS SELECTED. THE SELECTED SERIES ARE APT TO BE
SUBJECT TO ERRATIC VARIATIONS, AND THERE IS NO ASSURANCE
THAT THEY WILL REFLECT THE VARIATIONS IN THE PRICE LEVEL
OF THE GOODS AND SERVICES THAT INDIVIDUAL OPEC COUNTRIES
ACTUALLY IMPORT. ALSO, AVAILABLE PRICE INDICES FOR MAN-
UFACTURED GOODS DO NOT ADEQUATELY REFLECT CHANGES IN THE
QUALITY OF THESE GOODS. THESE INDICES, THEREFORE, ARE
LIKELY TO OVERSTATE ACTUAL PRICE INCREASES FOR GOODS IM-
PORTED BY OPEC COUNTRIES. AS A TACTICAL MATTER, HOWEVER,

CONSUMER COUNTRIES SHOULD AVOID CONCENTRATING THE DIALOGUE
ON THESE TECHNICAL PROBLEMS. DISCUSSING THESE PROBLEMS
AT LENGTH WOULD TEND TO DETRACT FROM THE COMPELLING
SUBSTANTIVE ECONOMIC ARGUMENTS AGAINST INDEXING AND MIGHT
GIVE THE WRONG IMPRESSION THAT INDEXATION, IN PRINCIPLE,
IS ACCEPTABLE.

M. INDEXATION WOULD HAVE THE ADDED DISADVANTAGE OF MAKING
THE CONSUMING COUNTRIES THE GUARANTORS OF OPEC PRICES. IT
WOULD PREVENT OUR TAKING ADVANTAGE OF INTERNAL FRICTIONS
OVER PRICING AND PRODUCTION POLICIES THAT MIGHT LATER ARISE
AMONG THE PRODUCERS.

N. INDEXATION DEALS WITH PRICE BUT IGNORES THE MORE

CRITICAL ISSUE OF CONSUMERS' ECONOMIC AND POLITICAL VUL-
NERABILITY TO OPEC PRESSURES. INDEXATION COULD CREATE
A FALSE SENSE OF CONFIDENCE AS TO FUTURE SUPPLIES AND
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UNDERMINE OUR COMMON EFFORTS TO SHIFT THE BALANCE IN THE WORLD OIL MARKET AWAY FROM THE PRODUCING NATIONS. EUCH AN ATTITUDE WOULD BE PARTICULARLY UNFORTUNATE SINCE, GIVEN THE PRODUCERS' PAST RECORD OF UNILATERALLY REVISING LEGAL AGREEMENTS (E.G. THE 1971 TEHRAN PRICE ARRANGEMENT AND CONCESSION CONTRACTS), WE COULD NOT AFFORD TO PLACE MUCH CONFIDENCE IN THEIR COMMITMENT TO LONG-TERM SUPPLIES AS PART OF AN INDEXATION SCHEME.

O. SHOULD OPEC PROPOSE A SUBSTANTIAL OIL PRICE REDUCTION COUPLED WITH A SCHEME FOR INDEXING OIL PRICES IN THE FUTURE, WE WOULD, OF COURSE, EXAMINE IT. HOWEVER, IT SEEMS UNLIKELY THAT OPEC WOULD AGREE TO A REDUCTION IN THE PRICE OF OIL LARGE ENOUGH TO MERIT SERIOUS CONSIDERATION OF SUCH A PROPOSAL. TH OIL IMPORTING COUNTRIES ARE NOT LIKELY TO BE NET GAINERS OVER THE LONGER TERM UNDER ANY FORM OF INDEXATION CONCEPT WHICH THE OPEC COUNTRIES WOULD ACCEPT. OPEC IS NOT LIKELY TO NEGOTIATE AWAY ITS ABILITY TO SET PRICES. RATHER OPEC WILL ONLY AGREE TO AN INDEXATION SCHEME THAT WILL YIELD CLOSE TO WHAT IT BELIEVES IT CAN ACHIEVE UNILATERALLY OVER THE LONGER TERM. MOREOVER, EVEN IF OPEC WERE TO ACCEPT INDEXATION BASED ON A MUCH LOWER OIL PRICE LEVEL THAN AT PRESENT, THE SHORT-RUN GAINS MIGHT STILL BE OUTWEIGHED BY SOME OF THE MAJOR DISADVANTAGES CITED ABOVE, PARTICULARLY THE ENCOURAGEMENT THAT WOULD BE GIVEN TO INDEXATION OF OTHER COMMODITY PRICES.

RECOMMENDED IEA POSITION:

P. THE IEA MEMBERS SHOULD CONTINUE TO TAKE A STRONG POSITION AGAINST THE INDEXATION OF OIL PRICES. THE ECONOMIC ARGUMENTS AGAINST INDEXATION ARE OVERWHELMING. SINCE THERE WAS NO ECONOMIC RATIONALE FOR THE SHARP INCREASE IN OIL PRICES AFTER OCTOBER 1973, THERE CAN BE NO ECONOMIC JUSTIFICATION FOR FURTHER PRICE INCREASES BASED UPON "INDEXATION."

TALKING POINTS (VIS-A-VIS OIL PRODUCERS):

Q. THE ECONOMIC ARGUMENTS AGAINST INDEXATION OF OIL PRICES AREC
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.....A. THE FREEZING OF OIL PRICES RELATIVE TO OTHER
.....COMMODITIES WOULD DISTORT RESOURCE ALLOCATION,
.....LEADING TO EXCESS SUPPLIES OR SHORTAGES.

B. IT WOULD INTENSIFY INFLATIONARY SPIRALS, PER-
..... PETUATE RECESSION, DECREASE THE REAL VOLUME

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..... OF WORLD TRADE, AND MOST IMPORTANTLY, REDUCE
.....RATES OF ECONOMIC GROWTH THROUGHOUT THE WORLD.

C. IT WOULD
ESTABLISH A PRECEDENT WHICH, IF APPLIED
..... TO OTHER COMMODITIES, WOULD SERIOUSLY FURTHER
..... EXACERBATE INFLATION AND DETER WORLD ECONOMIC
..... GROWTH AND PROGRESS.

.....D. AS A MEANS OF TRANSFERRING RESOURCES TO THE
.....DEVELOPING COURIES, IT IS INEFFICIENT AND
.....INEQUITABLE. OTHER MEASURES ARE MORE SUITABLE
.....FOR THAT PURPOSE.

REFERENCE: OECD, IEA, GOVERNING BOARD, "INDEXATION OF
..... COMMODITY PRICES WITH SPECIAL REFERENCE TO OIL,"
.....MARCH 4, 1975. KISSINGER

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